No. 20,845

United States Court of Appeals

For the Ninth Circuit

KENT-REESE ENTERPRISES, INC., RAYMOND DOUGLASS and ROBERT REESE,
Appellants,

vs.

WALTER HEMPY, Trustee of Big Boy Markets, Inc., Bankrupt.
Appellee.

APPELLEE'S ~~REPLY~~ BRIEF

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JURISDICTION

Jurisdiction is admitted by Appellants and has been at all stages of the proceedings. See Title 28 of the United States Code, Sections 1291, 1294, 1331 and 1334.

STATEMENT OF THE CASE

This is an appeal by the defendants from a judgment by the District Court declaring that certain transactions between the bankrupt, Big Boy Markets, Inc., the controlling directors, Raymond Douglass and Robert Reese, and another corporation controlled by the same two individuals, Kent-Reese Enterprises,

Inc., were preferential transfers in violation of the provisions of Section 60 of the Bankrupcy Act.

The Court indicated that the applicable law is authoritatively explained in the decision of *Aulick v. Largent* (1961) 295 Fed. 2d 41. That decision is not discussed or mentioned in appellant's opening brief.

The controversy stems from a document, introduced as Exhibit 15 in these proceedings, entitled "Receipt for Sum Deposited for Purchase of Preferred Stock; Guarantee of Repayment by Interested Corporation; and Provisions for Transfer of Credits, etc." This document was drafted by C. Wadsworth White, Esq., attorney for appellants herein, and attorney for all interested parties at the time of the transactions in question.

Appellee supports the trial court's findings that:

1. All elements of a voidable preference are present.

2. The transfer of the promissory note (which was the obligation of Kent-Reese to the bankrupt) to defendants Reese and Douglass took place immediately prior to the filing of the petition in bankruptcy, thus creating a voidable preference within four months of the filing of the petition in bankruptcy, despite the earlier date of the purported guaranty agreement.

3. The transfer was thus fraudulent against creditors and voidable by appellee.

The appellants' apparent claim that the guaranty agreement created an earlier security or "lien" (more than four months prior to the filing of the petition in

bankruptcy) is refuted by the absence of perfection under applicable state law.

The only real question is the date of the transfer of the promissory note (and the rights thereunder) for the purpose of determining whether a voidable preference was effected. The trial court found that the actual date of the transfer was immediately prior to the filing of the petition in bankruptcy and the findings of fact, which are unchallenged, support that result as does the applicable case law.

The interpretation of the pertinent document, in regard to any ambiguity therein, should and must be against the existing factual background. The two corporations were, in all respects, controlled by the individual appellants, Raymond Douglass and Robert Reese, who had the ability to arrange the corporate affairs in any way they chose. The ambiguous agreement and the other dealings were created by them at their pleasure and, therefore, in case of doubt, should be construed against them.

STATEMENT OF FACTS

Appellants, in their Specification of Errors (appellants' opening brief, pages 4-5), do not set forth as erroneous any of the findings of fact of the trial court; thus the findings of fact as set forth by the trial court should be accepted as true and correct for the purposes of this appeal.

We do not feel that the Statement of the Case, set forth by appellants on pages 2-5 of their opening

brief, is completely consistent with the facts as developed by the record or as found by the court. Therefore, the appellee adopts the findings of fact as set forth by the District Court without variation therefrom.

ARGUMENT OF CASE AND LAW

PAYMENT BY KENT-REESE CONSTITUTED A PREFERENCE VOIDABLE UNDER SECTION 60 OF THE BANKRUPTCY ACT.

A. All elements of a preference are present; transfer had not been perfected prior to bankruptcy since other creditors still had rights.

The elements of a preference are as follows: "a debtor (1) making or suffering a transfer of his property, (2) to or for the benefit of a creditor, (3) for or on account of an antecedent debt [resulting in a depletion of the estate], (4) while insolvent, and (5) within four months of bankruptcy or of the original petition under Chapters X, XI, XII, or XIII of the Act, (6) the effect of which transfer will be to enable the creditor to obtain a greater percentage of his debt than some other creditor of the same class." (3 *Collier on Bankruptcy,* pp. 758-9.)

All of the elements of the preference are admitted by Appellants except that the transfer of property by the bankrupt was made within four months of bankruptcy. Appellants contend that the transfer occurred earlier; i.e. element number (4) has been disputed. Before examining this crucial point, let us examine the authority relied upon by the court.

The present factual situation is strikingly similar to the situation considered by the Court of Appeals in the case of *Aulick v. Largent* (4 Cir.) 295 Fed. 2d 41 (1961). In that case the bankrupt was indebted to Aulick on a pre-existing unsecured indebtedness. Aulick was called upon to make good on this indebtedness. Following negotiation, it was agreed that Aulick would accept the bankrupt's personal note if endorsed by a third party, Lemley.

Lemley agreed to endorse the note if he was given certain corporate stock to secure his liability as an endorser. The security was given and the stock was pledged.

Bankruptcy followed within four months. Aulick recovered from Lemley on his guarantee.

The trustee in bankruptcy sued Aulick to recover the value of the stock on the theory that the pledge constituted a voidable preference in favor of Aulick. Judgment was entered in favor of the trustee and was affirmed as against Aulick upon appeal.

In both the *Aulick* case and the present case, all parties were aware of insolvency at the time of the transfer and insolvency existed without doubt. In both cases the transfer was on account of an antecedent indebtedness. In each case, the transfer was to a third party to secure a guarantee of the payment of the preexisting indebtedness.

The only difference between the *Aulick* case and the present case is the date of the pledge. In the *Aulick* case the pledge occurred within four months

of bankruptcy. In the present case the purported guaranty agreement was executed more than four months prior to bankruptcy, *but was never perfected as required by State law.*

Bankruptcy Act Section 60a(2) defines perfection for the purpose of determining whether a preference has been made. That section provides:

> "a transfer of property other than real property shall be deemed to have been made or suffered at the time when it became so far perfected that no subsquent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee."

When a transfer has not been so perfected, Section 60a(2) of the Bankruptcy Act provides:

> "If any transfer of real property is not so perfected against a bona fide purchase, or if any transfer of other property is not so perfected against such liens by legal or equitable proceedings prior to the filing of a petition initiating a proceeding under this Act, *it shall be deemed to have been made immediately before the filing of the petition."* (Emphasis added.)

All of Appellants' discussion as to guarantees and suretyship is meaningless. The question is whether the creditors' rights of Douglass and Reese had been *perfected* at some period prior to the four-month period which would preclude a bona-fide purchaser or creditor from acquiring superior rights in the property transferred by the bankrupt. This is the final question presented in *In Re Quaker City Sheet Metal*

Co., 129 Fed. 2d 894 (1942) and *In Re Kaufman,* 142 Fed. Supp. 759 (1956). In those two cases under Pennsylvania and Kentucky law, respectively, it was found that the purchaser or creditor could have acquired superior rights.

In the instant case in effect a promissory note was returned, cancelled or set off as consideration for payment of the full amount due two creditors, Douglass and Reese, who obtained thereby a preference over other creditors. That it was a third-party beneficiary contract is of no moment. *Pennington v. Legg,* 183 Fed. Supp. 884 (1960) and *Aulick v. Largent,* supra.

The funds due on the promissory note as they became payable could be garnisheed by a creditor, *Walters v. Bank of America,* 9 Cal. 2d 46, 69 Pac. 2d 839 (1937), and a set-off can not be invoked to defeat this right. At page 57 the court said:

> To allow the garnishee to claim his right of set-off to defeat the claim of the creditor . . . would result in an unwarranted interference with the rights of other creditors of defendant. Its (garnishee's) liability is not determined by an agreement between itself and the judgment debtor as to the application of the fund, but by the law which defines its liability as such garnishee. . . .

The promissory note itself in the hands of Big Boy Markets could have been attached or sold until cancelled or surrendered. In *Hecht v. Smith,* 183 Cal. App. 2d 723 (1960), the court said, on page 726:

> A negotiable promissory note is something more than mere evidence of indebtedness. It is property

> which can be subject of manual delivery. . . . may be here attached in a proper case. . . . It [such a note] "is a promissory note, negotiable in form, which passes in the commercial world by indorsement and delivery and is subject to sale. . . ."

If the note had been sold or attached prior to insolvency neither the guaranty nor a subsequent right of set-off would have matured.

Thus the bona fide purchaser or creditor could have gained superior rights to the two creditors prior to the insolvency and within the four-month period.

B. Date of transfer of funds or credit controls and not date of surety agreement.

The District Court has found that the alleged agreement of November 1, 1959,

> "did not effectuate a present assignment or transfer of said promissory note concurrently with the execution of said agreement, and any such transfer is deemed by law to have been made immediately before the filing of the petition in bankruptcy." (Findings and Opinion, page 6, lines 28-32.)

This promissory note constituted the Kent-Reese obligation to Big Boy, the bankrupt. According to the District Court's findings, the transfer of the obligation from Big Boy to defendants Reese and Douglass then took place at that time—immediately prior to filing the petition in bankruptcy. Actual payment, of course, came some time later.

Thus the assignment at that time was a voidable preference and a fraudulent transfer under the Bankruptcy Act. (Findings and Opinion, page 7, lines 16-18.) This is a correct finding under applicable law.

The date of the agreement of indemnity, guaranty or surety is not controlling, but the date upon which the funds were transferred or the credit actually given does control. A somewhat analogous case is *Davis v. Woolf,* 147 Fed. 2d 629 (1945), which reads, on page 632:

> [T]he rule, for which there is ample authority, that if property is transferred to a surety after he has become bound upon his guaranty, in order to indemnify him from loss and the principal is insolvent at the time of the transfer, it is a preferential transfer and may be recovered by the trustee in bankruptcy of the principal under § 60, sub. a, of the Bankruptcy Act, 11 USCA § 96, sub. a, if the other conditions therein prescribed for a recoverable preference concur. . . .
>
> It is equally true that if a surety pays or provides funds for the payment of a debt and the principal transfers property to the surety to indemnify or reimburse him, this is a preference of the surety in the event of the principal's bankruptcy and the existence of the other conditions which are declared by the Bankruptcy Act to constitute a preference. [citations] In such case the estate of the bankrupt is not enhanced in the least by the money advanced by the surety at the time of the transfer because the surety receives property equal to the value of the money advanced and the only purpose and effect of the

> transaction is to substitute the surety as a principal creditor for the amount of the debt.

It was in the bankruptcy petition itself (which Douglass helped prepare) that the decision is revealed to treat the guaranty as coming into effect by not listing either the note as an asset or the claims of Douglass and Reese for the amounts previously advanced. Kent-Reese later paid the amounts represented by judgment herein to Douglass and Reese.

In *Wilson Brothers v. Nelson,* 183 U.S. 191, 46 L. Ed. 147 (1901), the agreement (power of attorney to take judgment at any time) was 13 years old, but was acted upon within the four-month restriction, and was declared a preference and against Congressional intent.

The question of creating secret liens is discussed in *In Re Quaker City Sheet Metal Co.,* supra, at page 896:

> [T]he purpose of Section 60, sub. a, as amended by the Chandler Act of 1938, was to strike down secret liens even though given for a present consideration.

Next, *In Re Kaufman,* supra, treats of equitable liens on page 760:

> [I]n 1950 Congress amended Section 60 of the Bankruptcy Act and it now provides that the recognition of equitable liens would be denied where available means of perfecting a legal lien have not been employed.

As previously mentioned, Kent-Reese made no claim for the amounts which it had to pay Douglass and Reese. In a surety bond case the United States Supreme Court barred such collection. *American Surety Co. v. Sampsell,* 327 U.S. 269, 90 L. Ed. 663 (1946).

The date of the transfer which would create a preference—namely, the treatment of the promissory note as fully set off by the amount due to Douglass and Reese—is clearly within the four-month period prior to the petition.

C. There was no immediate transfer of possession, on November 1, 1959, as required under state law; the transfer is therefore voidable as a fraudulent conveyance.

California Civil Code Section 3440, as of November 1, 1959, the date of the pertinent agreement, provided as follows:

> "Every transfer of personal property and every lien on personal property made by a person having at the time the possession or control of the property, and not accompanied by an immediate delivery followed by an actual and continued change of possession of the things transferred, *is conclusively presumed fraudulent and void as against the transferor's creditors* while he remains in possession and the successors in interest of those creditors, and as against any person on whom the transferor's estate devolves in trust for the benefit of others than the transferor and as against purchasers or encumbrancers in good faith subsequent to the transfer.
>
> Exceptions. This section shall not apply to any of the following:
>
> . . .

(c) *Mortgages allowed by law,* and contracts of bottomry or respondentia.

. . .” (emphasis added)

The bankrupt had possession of the promissory note at all times. There was no immediate transfer of possession.

Section 3440 holds that the transfer is a fraudulent conveyance, void as to creditors, *unless it is a mortgage.*

D. Assuming, arguendo, that the transfer gave rise to a mortgage, the mortgage is void.

California Civil Code Section 2957 provides that an unrecorded chattel mortgage is “void as against creditors of the mortgagor.” (Civil Code Section 2957 subd. 4.) The mortgage is also void if not acknowledged or proved and certified in the same manner required of a deed of real property. (Civil Code Section 2957 subd. 1.) The mortgage is also void unless it is clearly marked “apart from and preceding all other terms of the mortgage, to be a mortgage of crops and chattels, or either.” (Civil Code Section 2957, subd. 5.)*

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*§2957. Essential elements; recording; re-recordation.

A mortgage of personal property or crops is void as against creditors of the mortgagor and subsequent purchasers and encumbrancers of the property in good faith and for value, unless;

1. It is acknowledged, or proved and certified, in like manner as grants of real property;

. . . .

4. The mortgage, if of personal property other than crops growing or to be grown or animate personal property, is recorded in the office of the recorder of the county where the property mortgaged is located at the time the mortgage is executed, and also in the county to which such property is there-

From the said agreement, it clearly appears:

(1) The document is unrecorded.

(2) The document was not acknowledged as required of deeds in California.

(3) The document is not entitled at the top, "Mortgage of Chattels."

Thus, if the document is a mortgage of chattels, it is void.

CONCLUSION

The only question at issue—at the time of giving a preference to appellants which would create a voidable preference constituting a transfer fraudulent against creditors—is settled in favor of appellee trustee in bankruptcy on several grounds:

1. The rights of the appellants were not perfected against other creditors until immediately prior to the filing of the petition in bankruptcy within the statutory four-month period;

2. The transfer of actual credits did not take place until immediately before the filing of the petition in bankruptcy which is the controlling date under case

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after removed, and also in the county where the mortgagor resides at the time the mortgage is executed; provided that in case the mortgagor is a nonresident of this State, the recordation of the mortgage in the county where the property is located at the time the mortgage is executed and also in the county to which such property is thereafter removed shall constitute compliance with the provisions of this section;

5. Each such mortgage is clearly entitled on the face thereof, apart from and preceding all other terms of the mortgage, to be a mortgage of crops and chattels, or either;

. . ."

law (and the actual funds were not transferred until a time after said petition had been filed);

3. The transfer of the rights to the promissory note which represented the obligation to the bankrupt were not perfected according to the applicable state law prior to the filing of the petition in bankruptcy.

Thus, the findings and opinion of the District Court in favor of appellee are fully substantiated.

It is respectfully submitted that the decision of the District Court be affirmed.

Dated, San Francisco, California,
November 12, 1966.

Respectfully submitted,
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Attorneys for Appellee.

Certificate of Counsel

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

William Kelly,
Attorney for Appellee.